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STATE FOR SCA/INS AND EEB
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DEPT PASS TO USTR MDELANEY/CLILIENFELD/AADLER
DEPT PASS TO TREASURY FOR OFFICE OF SOUTH ASIA MNUGENT
TREASURY PASS TO FRB SAN FRANCISCO/TERESA CURRAN

E.O. 12958: N/A
TAGS: EAGR ECON EFIN EINV ETRD IN

SUBJECT: INDIA MANAGING IMPACT OF GLOBAL FINANCIAL CRISIS ALTHOUGH DISTRACTED BY ELECTIONS AND REGIONAL TENSIONS

REF A) SECSTATE 00134459 B) 08 NEW DELHI 002995 C) NEW DELHI 00022
D) 08 NEW DELHI 00003177 E) 08 NEW DELHI 3143 F) NEW DELHI 000044

¶1. (SBU) Summary. Per Ref A, Mission provides an update on how India is weathering the global financial crisis and subsequent economic slowdown and on the political economy of the impact and government response. India's economy, already slowing from lower domestic spending in a high interest regime, has also been hit since October by decreased global demand for its textiles and jewelry, as well as seeing private and public investment in infrastructure and capacity expansion stymied by frozen credit markets (ref B). Two stimulus packages were dominated by relatively aggressive monetary loosening and foreign financing liberalization, along with some targeted fiscal support. Most economists still expect the Indian economy to expand between 6-7% in the current fiscal year, ending March, and then to fall to a 5-6% growth band for the rest of 2009. National elections by May and tensions with Pakistan may limit Prime Minister Singh and his economic team from contributing more to G-20 efforts than these domestic responses. End summary.

FISCAL STIMULUS PACKAGES

¶2. (SBU) The Government of India and the central bank, the Reserve Bank of India (RBI), have created two stimulus packages in the last month (ref C and D). Since big populist programs this year already limited the government's capacity to spend, the fiscal stimuli were very modest, mainly targeting the hard hit sectors of infrastructure, real estate, and SMEs, which are labor-intensive. CRISIL's principal economist, DK Joshi, and IMF resident representative, Sanjaya Panth, both think there is little left the government can do on the fiscal side because of spending constraints. Indeed, when the government announced the January 2 package, it noted its intention that this would be the last fiscal package of the year, although a fuel price reduction is rumored.

¶3. (SBU) Monetary policy has notably loosened since September, and the two stimulus packages cumulatively brought the main policy lending rate down by 100 basis points to 5.5%, while the reverse repo rate, the rate at which the RBI pays banks for parking their funds with it, has been brought down to 4% to deter banks' preference to keep funds safe with the central bank rather than lend. These moves, along with reductions in the cash reserve ratio (CRR) and government pressure on public sector banks, have prompted a few banks to lower their deposit and lending rates, although the prime lending rate has barely moved. Vaishali Nigam Sinha, Senior Vice President, Macquarie Capital Advisers, thinks the first

stimulus package has eased borrowing for some companies, especially in the infrastructure and real estate sectors. In addition, bankers in Mumbai think that trade finance has eased recently. However, RBI data shows banks are still parking significant funds with the central bank, suggesting that liquidity has eased but banks are still hesitant to lend. Meanwhile, regional economic differences limit the usefulness of looser monetary policy. Our Consulate in Kolkata noted that commodity-consuming industries in resource-rich eastern India are struggling with lower commodity prices and higher inventory and are not in need of working capital.

FINANCIAL REFORMS SLOWLY SOLDIER ON

¶4. (SBU) Commendably, the regulators have continued with planned, albeit incremental, financial liberalization while the government has introduced newer measures to encourage capital inflows. In response to a net outflow of portfolio investment, the stock market regulator, SEBI, removed the ban on participatory notes, a form of derivative portfolio investment. The Ministry of Finance also loosened the restrictions on external commercial borrowings and raised the cap on foreign portfolio investment in the corporate debt market. Finally, RBI continued with its rollout of futures derivatives last fall and is on track to launch interest rate derivatives this month.

ECONOMIC OUTLOOK: STILL MIXED, LESS DIRE

¶5. (SBU) Since steep contractions were noted in October export and production data (ref B), recently released November production and

infrastructure data shows a return to positive territory, although still off from strong showings last year at the same time. The index of industrial production (IIP) rose 2.2% in November compared to 4.9% growth in November 2007; April-November growth was 3.6% compared to 6.4% during the same period in 2007. Preliminary estimates of exports in December were still off, but only down by 1%, compared to the October year-on-year plummet of 12%. Meanwhile, some major Indian steel companies noted this week that domestic demand seems to be picking up and they are planning to return to full production after having cut back in late 2008.

¶6. (SBU) Some sectors of the Indian economy continue to hurt, especially textile and gems and jewelry exports and auto component domestic and export sales (ref F). The Ministry of Commerce has revised downwards its export target for the fiscal year from $200 billion to $175-180 billion. Total exports last fiscal year were $162 billion; exports from April to December were $130 billion, representing the 30% growth exports experienced in April to August. The stimulus packages had some targeted concessions for these groups, but industry representatives say they are not enough.

¶7. (SBU) Although the balance of payments turned negative in the April to September quarter (latest available data), foreign exchange reserves, at $250 billion, remain sufficient to cover 2.5 times short term debt. Since much of the April-September trade deficit was due to the peak oil prices over the summer, analysts expect the import bill to fall in the coming months, although declining exports mitigate the improvement. Anecdotally, foreign worker remittances remained strong through December, especially through government-sponsored Non-Resident Indian (NRI deposits), whose deposit rates were raised to attract such funds. India leads the world in remittances, last year earning roughly $40 billion. Foreign exchange reserves have not fallen in recent weeks and the rupee has remained in the 48-49 range. This suggests that capital flows may have stabilized compared to the $60 billion loss in reserves last year as the RBI intervened in forex markets to mitigate the rupee's roughly 20% depreciation from September to December.

BILATERAL TIES NOT HARMED

¶8. (SBU) Post has not seen any signs of negative fallout from the

financial crisis on bilateral relations. Indeed, when Post delivered the recent G-20 demarche to the Ministry of Commerce and Industry (ref E) on how the government's November increase in several import tariffs went against the G-20 Communique, the Ministry's response was mild and rather technical in nature. Government officials have not spoken critically of any US domestic policy moves, and in recent months, have not framed the global economic slowdown as the US' fault. The government has not instituted any additional tariff increases since the raising of several import duties in November, although it remains under pressure from industry to do so.

ELECTIONS LOOMING; GOVERNMENT DISTRACTED

¶9. (SBU) While the GOI has crafted two stimulus packages, domestic politics are strongly dominating government bandwidth these days. The two main events are approaching national parliamentary elections, which must take place no later than the April-May timeframe, and ongoing tensions with Pakistan in the wake of the November Mumbai attacks. The government was probably motivated to move quickly on the stimulus packages, a key recommendation of the G-20 summit, because mitigating the economic slowdown is in the ruling coalition's interest as it prepares for elections. However, active G-20 participation by India in the next few months may be constrained by election preparation. In addition, the government is preoccupied with a "coercive diplomacy" effort to pressure other governments to apply harder pressure on the Pakistani government to move against the perpetrators of the Mumbai attacks.

¶10. (SBU) India's apparent attempt to pursue non-military responses could lead it to seek punitive economic steps against Pakistan, which would go against the spirit of the G-20 Communique supporting united efforts towards world growth. Home Minister Chidambaram was quoted in the London Times this week (and widely re-quoted) as

threatening to sever trade and civil ties with Pakistan if it did not take adequate steps to help find those responsible for Mumbai. Meanwhile, Chidambaram's move to the Home Ministry in December has left the Finance Minister's position empty. Contacts have told Econoffs that Planning Commission Deputy Chairman Montek Singh Ahluwalia is informally filling the role in conjunction with Prime Minister (and a former Finance Minister) Singh. While they are both highly capable economic managers, the elections and regional tensions leave less room for the Prime Minister to dedicate to global issues.

COMMENT

¶11. (SBU) India's top economic leadership has so far rather deftly handled the impact on India of the global financial and economic downturn. But looming elections and regional tensions, combined with double-hatted economic management, could constrain India's ruling coalition from active leadership in the G-20 process in the coming months. However, these distractions may not matter much to India's economic performance during the next six months as several economists tell Econoffs that there is little left the government can do to mitigate the crisis. While forecasts on India's growth diverged significantly late last year, there is growing consensus on India's growth projections for the coming year as its trajectory becomes clearer. India's exports will have to ride out the global slowdown, but the country's domestic demand appears resilient enough to maintain growth in the 5-6% range through the worst of the global downturn and keep India as one of the fastest growing economies.

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